The Brazilian Economy after Lula: What to Expect?

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Introduction

Like Chile, which was governed by a left of center coalition for twenty years after the fall of Pinochet, Brazil, for the last sixteen years, has been ran by left of center parties under Fernando Henrique Cardoso and Luis Inácio Lula da Silva. The assumption of Dilma Rousseff guarantees the continuity of the left of center parties for another four years. Yet, contrary to the Chilean experience, in which Christian Democrats and Socialists, the main political parties in opposition to the dictatorship, formed a coalition, in Brazil the two main parties, the Party of Brazilian Social Democracy (PSDB) and the Worker's Party (PT) have been political rivals.

The political differences between the two main political parties in Brazil, which trace their origins to left of center groups in São Paulo that resisted the long Brazilian dictatorship (1964–85), do not translate in significant dissimilarities in terms of macroeconomic policy. The pillars of the macroeconomic policy have been the use of the exchange rate as an anti-inflation instrument, which has not changed with the implementation of inflation targeting since 1999, and the maintenance of primary surpluses, even though in the second half of Lula's government, and particularly after the 2008–9 global crisis, counter cyclical fiscal policy was pursued. Perhaps the most distinctive characteristic of Worker's Party administrations, in comparison with the preceding one, is the expansion of the social programs and the minimum wage, and the consequent improvement in income distribution.

The remainder of the paper is divided in three parts. The first looks at the economic performance since the first of Lula's terms, with an emphasis on the main characteristics of the macroeconomic policy framework. The following section discusses the social programs and the evolution of income distribution. The last section analyzes what can be expected from the Worker's Party third term in command of the Brazilian administration.

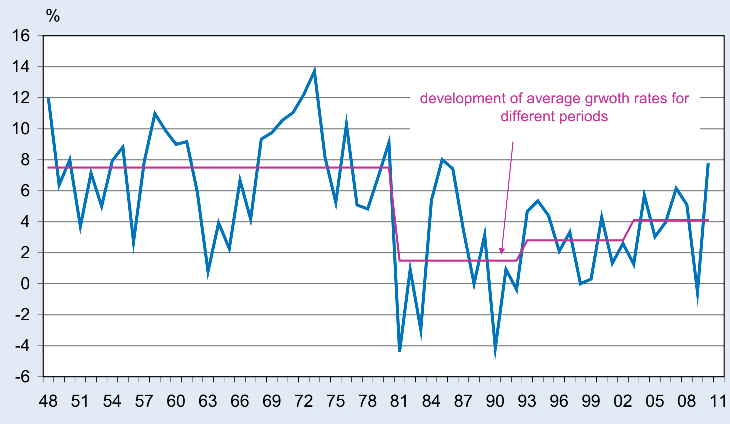
Locomotive or brake-van?

Ever since an economist at Goldman Sachs suggested that Brazil, together with Russia, India and China, was part of a special group of economies, the BRICs, that would take over world GDP before mid-century, the Brazilian economic performance has been lionized in the international media. The perception, however, of Brazil as one of the locomotives of global economic growth in the twenty-first century is peculiar, to say the least.

During the long period associated with the state-led development strategy, roughly from the late 1940s to around 1980, Brazil grew at an average of 7.5 percent per year. The debt crisis led to the so-called lost

Figure 1

Real GDP Growth, 1948–2010



Source: IPEA Data.

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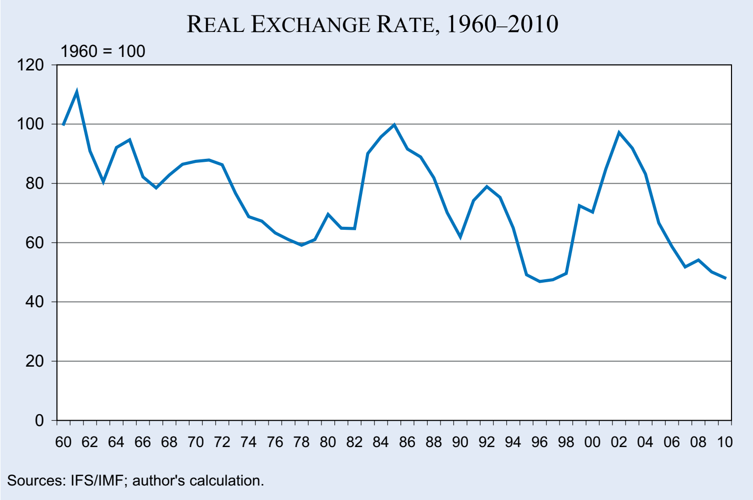
decade, which implied rates of growth, on average, of 1.5 percent, which was considerably better than for the rest of Latin America during this period. The stabilization period, associated to Fernando Henrique Cardoso's tenures as Finance Minister and President, spanning from 1993 to 2002, was associated with a small recovery in the rates of economic growth to 2.8 percent. It should be noted that starting in the late 1980s, a significant process of liberalization in the context of the Washington Consensus doctrines has been implemented in Brazil.

Figure 2



In that sense, many economic analysts believed that Lula's election foreshadowed a reversal in development strategy, one that would reverse several of the liberalization policies of the previous decade. As it turned out the break with previous policies was considerably less marked than expected, and in many respects Lula's administration represented a continuation of the liberalizing policies of the 1990s. The economic performance as measured by the real GDP growth, showed improvement, with a rate of growth of 4.1 percent per year on average, but this was a global phenomenon. Additionally, Brazil grew only slightly above the world average of around 3.4 percent, and considerably below the start performers in Asia and Latin America. In other words, the Brazilian economy was not leading the world economy in terms of growth, and was far from the perceived view as one of the world's most dynamic economies.

The reasons for the relatively poor performance in terms of growth, when compared to more dynamic economies in the developing world, are obviously complex and have many causes. But it is fairly reasonable to suggest that macroeconomic policies are central to any explanation of the growth performance. It should be noted that Brazil has had, since stabilization in 1994, one of the highest, if not the highest, real rate of interest in the world. Further, the high rates of interest combined with a relatively unregulated capital account, has led to significant capital inflows and a long term tendency to foreign exchange appreciation, punctuated by external crisis.

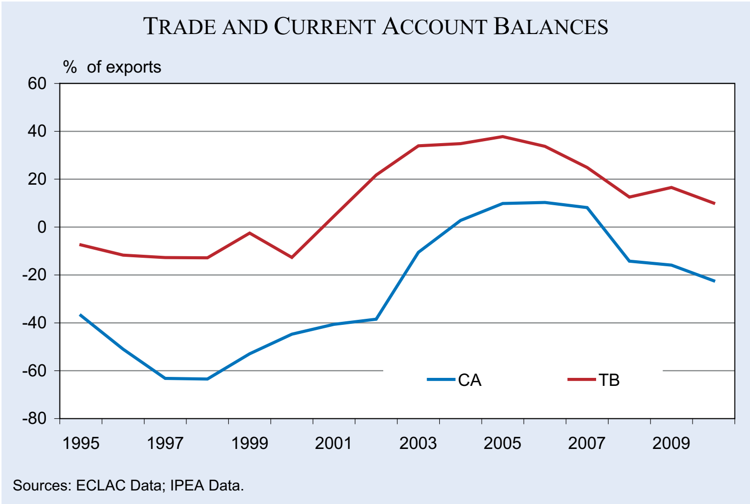
In fact, exchange rate appreciation has been the main instrument to control domestic prices, since stabilization and still after the implementation of the inflation-targeting framework (Vernengo 2008). Figure 2 shows the evolution of the real exchange rate (RER)[1] over time, and the peculiar Latin American tendency to appreciation, punctuated by severe depreciations in time of crisis is clearly visible (Frenkel and Rapetti 2010). In the Brazilian case, the significant real exchange rate depreciations were in the midst of the debt crisis in the early 1980s, with the collapse of the Collor Stabilization Plan in the early 1990s, and in 1999, after the Asian and Russian financial crises.

The tendency to exchange rate appreciation is particularly problematic for countries with a balance of payments constraint, as it is the case with developing countries, including Brazil. In particular, countries that have an external constraint cannot maintain a trade deficit, or a negative balance in the current account, for prolonged periods, without significant capital inflows. The implication is that the risk of external crises is higher, and that policies that reduce the possibility of external default should be favored.

The most reliable source of foreign funds is the one that comes from export revenues. While export dynamism depends on several factors, it is clear that an appreciated exchange rate reduces external competitiveness. In the state-led development period exports grew at an average yearly rate of 10.3 percent, which fell to around 5 percent during the two follow-

[1] Measured as the domestic price of foreign currency, which means that an appreciation is represented by a decline in the exchange rate.

Figure 3



ing decades. However, after 2002 the rate of growth of exports picked up, and achieved an unprecedented 17.7 percent. It is clear that the growth of the global economy, in particular the fast growth of the Chinese and Indian economies, created space for higher rates of growth around the globe.

However, the effect of an appreciated exchange rate on the demand for imports compensated export dynamism in the last period. As can be seen in Figure 3, the real exchange rate appreciation of the early 1990s implied significantly large trade (TB) and current account (CA) deficits as a share of total exports. The 1999 crisis, and the depreciation of the real, allowed for surpluses during the 21st century, but the tendency to appreciation reduced the trade surpluses and led to current account deficits by 2008.

This is not to suggest that the Brazilian economy is approaching an external crisis, as it did in 1999, since the current account deficits are still relatively small, and Brazil has a large amount of foreign reserves – approximately 240 billion US dollars at the end of 2009. However, it shows that the Brazilian economy cannot grow at Chinese levels without incurring into significant trade and current account deficits, and that, as a result, the pace of growth must be more moderate.

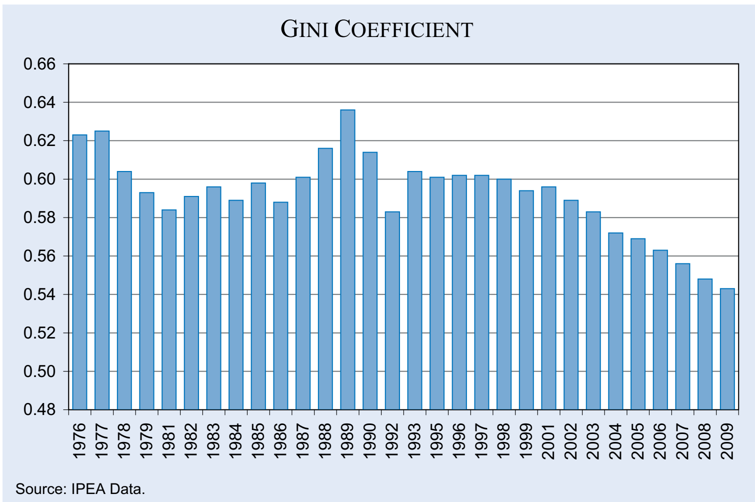
The recent appointment of Alexandre Tombini, a fairly conservative economist, to head the central bank, and the continuity of the tightening of monetary policy, which started in April 2010, shows that the exchange rate will continue to be used as the main instrument of inflationary control by the new administration. The implication is that the policy mix of high real rates of interest, and appreciated exchange rates will remain in place, and the Brazilian rates of economic growth will remain well below the ones of the more dynamic developing countries.[2]

A new middle class?

If the participation in the BRICs, as one of the most dynamic economies of the world, was the hallmark of the international perception of Brazil in the 21st century, then the improvement in income distribution and the appearance of a new middle class has been central to the domestic perception about the dominant changes in the new century (e.g. Neri 2008). The excitement about the so-called new middle class is associated to what has been publicized as a significant improvement in income distribution, often connected to the increase in social spending.

It is true that the evolution of the Gini coefficient shows an improvement starting in the late 1990s, a few years after stabilization, and before the election of Lula (see Figure 4). The Gini coefficient falls from

Figure 4

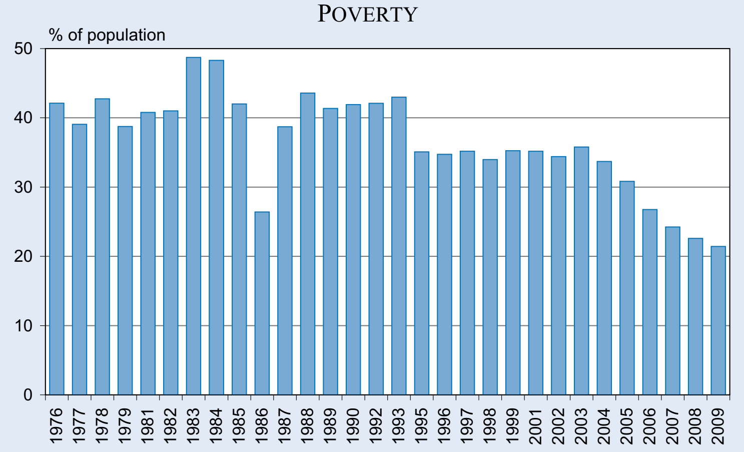


[2] For a critique of this macroeconomic policy mix, see Bresser-Pereira (2007).

of social policies implemented by left-of-center administrations), which implied that a certain skepticism was guaranteed when discussing the recent trends in social indicators.

The average real remuneration of workers in the metropolitan region of São Paulo, the most advanced industrial center in the country, has not improved, and, in fact, has decreased significantly since the mid-1990s, remaining constant at lower levels during the two terms of Worker's Party administration (see Figure 6).

Figure 5



Source: IPEA Data.

around 0.6, one of the highest levels of inequality in the world which would be compatible with a poor country, to close to 0.54, still an incredibly high level of inequality, but closer to what a middle income country like Brazil might have.

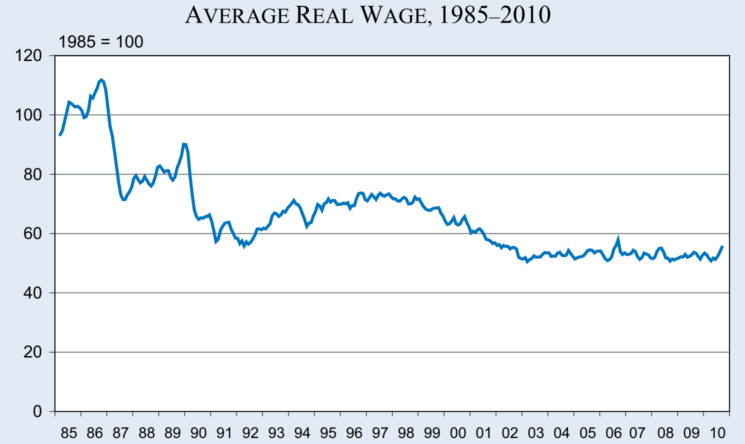
As important as the improvement in income distribution for the discussion of the rise of the new middle class has been the reduction in poverty rates, which fell from close to 35 percent of the population in the mid-1990s to approximately 20 percent at the end of Lula's second term. As with income distribution, it is clear that from the late 1990s onwards there is a significant improvement, as can be seen in Figure 5, and the same occurred with extreme poverty that fell from around 15 to slightly above 7 percent in the same period.

As I noted in a previous work,[3] however, Gini coefficients are not necessarily a good measure of income inequality in many developing countries, and other social indicators, besides poverty, had improved since the 1940s (i.e. before the current set

The apparent contradiction of an improvement in income distribution and a stagnant real wage is reconciled by the fact that the wages of the lower income strata, in particular, the minimum wage have increased at a faster pace.[4] Further, the participation of wages in total income remains below its level from the early 1990s, despite some improvement in Lula's last presidential term (see Figure 7).[5]

It is true that the improvement in the functional distribution of income in the second term of the Worker's Party administration implied that by the end (available data up to 2008) of the whole administration wages were higher than at the start in 2003. Yet, they remain lower than when Fernando Henrique Cardoso assumed the government in 1995, and still lower than in 1990, when it was around 37 percent (46 in the extended measure) of

Figure 6



Source: IPEA Data.

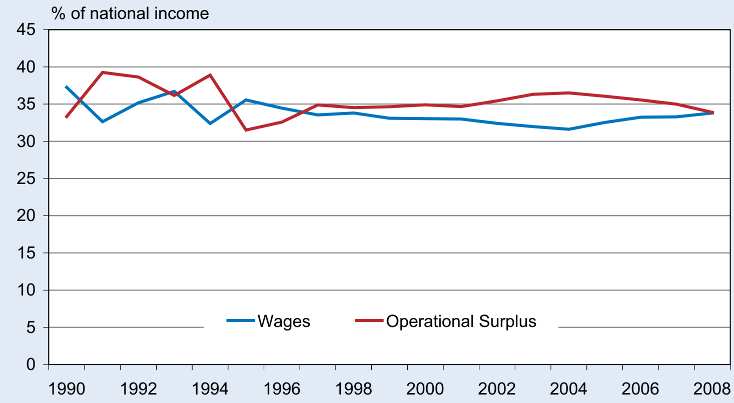
[3] See Camara and Vernengo (2006) for an analysis of social policies during Lula's first term in office.

[4] Serrano (2010) correctly points out that, while the rate of interest and the exchange rate have been the instruments of inflation-targeting, the stagnation of real wages is the anchor of price stability.

[5] If one includes other remuneration of labor, besides wages, total remuneration is higher, at around 41 percent of national income in 2007 (IPEA, 2008) and 42.7 percent in 2008, but follows the same trajectory of wages, which were just below 34 percent in 2008, virtually the same level that operational surplus. The latter, it should be noted is also higher once other remuneration of capital is included.

Figure 7

FUNCTIONAL INCOME DISTRIBUTION



Source: IPEA Data.

national income. It is hardly the sort of earth-shattering event that is associated with the rise of a new middle-class.[6]

The unwarranted notion of a new middle-class is tied to the enlargement of social programs, and the expansion of credit, which has allowed the increase of consumption, and a change in some patterns of consumption with an increase in the proportion of consumer durables, in particular home appliances and consumer electronics, for the lower classes.

Further, it is far from clear that social spending, besides the expansion of the Bolsa Família has been a priority of the Worker's Party's administrations.[7] Table 1 shows that with the exception of the last year, in every year government spending with the service of public debt were higher than social spending on health and education combined, when both are measured as a share of total government spending.

Table 1

Government Spending (%)

	Interest	Social expenditure[a)]
1985	1.24	4.70
1990	4.14	4.70
2000	6.30	6.09
2004	8.19	6.45
2008	9.22	7.39
2010	8.61	8.82

[a)] Spending on Health, Education and Labor combined.

Source: STN.

Additionally, it is clear that interest payments have significantly increased in the 1990s, and have remained at relatively high levels throughout the Cardoso and Lula's administrations. The financialization of government spending, that is a direct result of high interest rates, reduces the policy space for social programs, particularly because primary targets for fiscal spending imply the scope for discretionary spending is small.

Further, since it is very unlikely, as we noted in the previous section, that monetary policy will change anytime soon, and it is very likely that price stability will remain central for monetary policy decisions, it is not clear that average real wages will suddenly start growing, or that functional income distribution will lead to a significant increase in labor's share.

What to expect?

The two previous sections try to demystify the Brazilian recent experience. As it can be seen, Brazilian economic performance has not been exceptional in the last decade. Also, and more importantly, the improvements in income distribution have been marginal, and do not guarantee the enthusiasm about a new middle-class that has swept the media coverage and the national conversation in Brazil.

It goes without saying that sheer size, and the ownership of strategic resources, from the Amazon forest to the recent discoveries of oil in the Atlantic coast, imply that Brazil is an important player in world politics, as shown by its leadership in the G20 group. And

[6] In colonial times, and up to the so-called Old Republic (1889-1930), the middle class was a small group of independent workers and liberal professionals, in an economy largely dominated by agricultural production for exports. It was the process of industrialization that expanded the range of the middle class, including the expansion of state bureaucracy, and the development of higher education institutions. Perhaps, the last significant enlargement of the middle class occurred, paradoxically, in the late 1960s, when the income concentration that resulted from the military regime economic policies, allowed for an incorporation of new groups into the economy, and an expansion of the patterns of consumption. Further, the new social classes organized in new institutions leading to the new unionism of the 1970s, from which the Worker's Party eventually emerged.

[7] Spending on Bolsa Família tripled from 2003 to 2010, but remains below 1 percent of total government spending in 2010. Coverage increased from 3.5 to 12.5 million families approximately, which implies that around 50 million people are covered. Bolsa Família is the largest social transfer program in Latin America.

it is also true that the so-called two-speed recovery, i.e. slow in advanced countries, and much faster in emerging and developing economies, suggests that Brazil will continue to grow faster than it did in the 1980s and 90s, but most likely considerably below the levels of the state-led development era.

The increase in the prices of commodities, in fact, favors the Brazilian expansion, since Brazil is not an importer of food, and is an exporter of commodities. The growth in exports, reduces the risks of external crises, and allows for more vigorous expansion of the domestic market. The expansion of credit, the strategic use of the National Development Bank (BNDES in Portuguese), and the continuity of the Plan for the Acceleration of Growth (PAC in Portuguese) bode well for the domestic demand expansion. The planned cut of 50 billion Brazilian *reals*, on the other hand, seems an early concession to conservative groups preoccupied with inflation.

Whether Dilma will expand the more progressive programs of Lula's second term, and allow the economy to grow at a faster pace, promoting a more significant redistribution of income, something that is sorely needed in a country that remains among the most unequal in the world, is far from certain. Early signs point out to a more moderate agenda, more akin to Lula's first term. Perhaps we may suggest, paraphrasing Marx, that the tradition of the dead administration 'weighs like a nightmare on the brains of the living'.

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